Daily Comment

By Bill O'Grady, Thomas Wash, and
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Looking for something to read? See our [Reading List](); these books, separated by category, are ones we find interesting and insightful. We will be adding to the list over time.

[Posted: November 7, 2019—9:30 AM EST] Global equity markets are generally higher this morning. The EuroStoxx 50 is up 0.3% from its last close. In Asia, the MSCI Asia Apex 50 closed up 0.2%. Chinese markets were mixed, with the Shanghai composite unchanged and the Shenzhen index up 0.6% from the prior close. U.S. equity index futures are signaling a higher open. With 383 companies having reported, the S&P 500 Q3 earnings stand at $42.40, higher than the $41.08 forecast for the quarter. The forecast reflects a 4.0% decrease from Q3 2018 earnings. Thus far this quarter, 76.0% of the companies reported earnings above forecast, while 16.7% reported earnings below forecast.

The second episode of the *Confluence of Ideas* podcast is available!

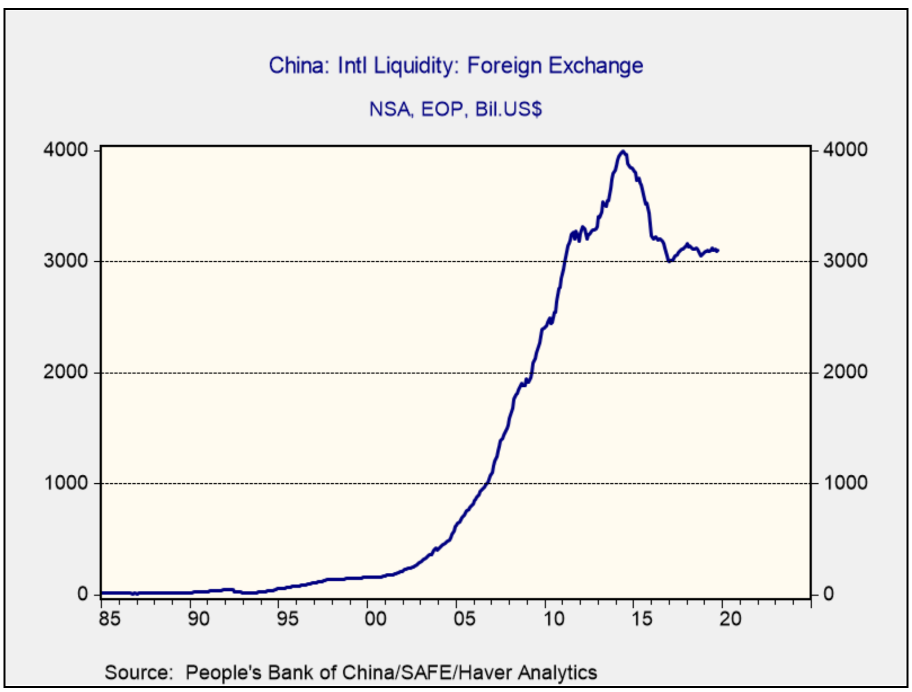
Trade optimism is lifted again this morning—risk assets are higher. The Happy Meal is 40 years old today. Trouble in techland. More on EU deposit insurance. DOE report. Here are the details:

Trade: Reports indicate the U.S. and China are preparing a phased reduction of tariffs. The details are scarce; so far, the reports suggest a rollback of tariffs on a proportional basis. However, it is still unclear if this news means that existing tariffs or proposed tariffs are part of the agreement. In some respects, we don't know much more on this issue than we did yesterday. We still don't have a venue for a signing ceremony and the mechanics of the tariff reductions are still unknown. If it ends up that we simply see tariff reductions but nothing new to show for it but agricultural purchases, it's hard to see what the point of the tariffs were in the first place.

There is an element of the rollback that looks like the U.S. is trying to avoid economic problems before the election. If that is the case, there are two issues that emerge. First, China will press hard to get as much as it can in this phase because it likely concludes that American negotiators are in a disadvantageous spot. Second, if Trump wins reelection, look for the tariffs to return. We still believe that tariffs and trade impediments are a core position of this president and the current negotiations represent a tactical retreat, not a surrender. However, for the short term, a rollback in tariffs and a trade truce is bullish for risk assets.

China financial issues: China's massive debt accumulation over the past 15 years has been well documented and, at some point, this mountain has to be addressed. Debt problems are difficult to avoid; investment is hard because it's about predicting the future and there will always be mistakes made. It's always important to remember that the opposite side of debt is an asset; in other words, one party's debt represents another party's asset. When a debt problem emerges, the political system is where the "cost of adjustment" is decided. In other words, how much pain will the debtor suffer relative to the creditor? China appears to be moving to address this issue. After years of forcing creditors to continue to provide credit to dodgy borrowers, the government appears to be allowing firms to fail and bankruptcy courts to adjudicate the adjustment costs. We view this as good news. Dealing with the problem is much better than simply putting it off. However, the process will almost certainly slow economic growth; in fact, forcing the economy to slow is a necessary component because pushing growth increases the odds of malinvestment. A slowing Chinese economy will adversely affect a world economy that has been dependent on Chinese growth but dealing with the debt issue in a systemic fashion reduces the likelihood of a financial crisis. The key unknown is if the CPC can manage expectations and its own legitimacy in the face of slowing growth. Chairman Xi has consolidated power and has a favorable chance to manage this transition. But, it isn't certain he can maintain the legitimacy of the CPC which had staked its reputation on delivering growth. In related news, Chinese financial officials appear to be consolidating the banking system to stabilize it and avoid runs from small bank failures.

October foreign reserves rose $12.7 bn, a bit more than forecast.



China-Hong Kong: In what may be Beijing's new approach to quelling the anti-China protests in Hong Kong, a key advisor to the Chinese government warned the city would suffer dire consequences if it doesn't adopt a national security law as required by its mini-constitution. Adopting such a law would likely allow a clampdown on the protests under the guise of being a home-grown policy; failure to adopt the law would be a ready excuse to fire municipal Chief Executive Lam.

United Kingdom: With the campaigning for the December election now in full swing, all the major parties are trying to gather support by promising big hikes in government spending. For example, Chancellor Sajid Javid of the ruling Conservative Party, which probably has the best chance of winning the election, today announced a change in the government's fiscal rules that will allow for spending £22 billion more on public infrastructure like roads and railways each year going forward. Not to be outclassed, the Labor Party said it would loosen its fiscal targets to allow for £55 billion more on public investment each year. Fearing a post-election borrowing binge, PIMCO Chief Investment Officer Andrew Balls says he is therefore steering clear of gilts.

Eurozone: The European Commission cut its forecast for the Eurozone's 2019 GDP growth to just 1.1% – a pace it said was "usually associated with the brink of recession." Citing its pessimism regarding trade tensions, the risk of a disorderly Brexit and soft global manufacturing, the Commission also cut its growth forecast to 1.2% for both 2020 and 2021.

Japan: For the first time in two years, a special Diet commission has resumed debating a first-ever amendment to Japan's pacifist constitution. Although the amendment would focus on changing the law related to referendums, it would also touch on Prime Minister Abe's dream of revising the war-renouncing Article 9 in order to allow Japan to boost its military and take a more muscular approach to international affairs. Changing Article 9 would not only require winning a two-thirds majority in both chambers of the Diet, but it would also require winning a majority in a national referendum. ***A key question is: Does anyone really want to see Japan rearm?***

Tech: The technology firms can't seem to get out of their own way. There are reports that Twitter (TWTR, 29.54) employees engaged in spying activity on behalf of the Saudi government. The state of California is investigating Facebook's (FB, 191.55) privacy practices, accusing the firm of not complying with subpoenas. With regards to Facebook, internal emails surrounding Whatsapp appear to indicate that the former may have engaged in anti-competitive practices.

They are Germans, after all: Yesterday, we noted that Germany was warming to EU-wide deposit insurance. The headlines suggested a breakthrough. Well, it appears that this "warming" has come with caveats. Essentially, Germany wants

1. Banks to buffer their exposure to government bonds with equity;

2. An almost radical reduction of non-performing loans;

3. A harmonized corporate tax base for banks.

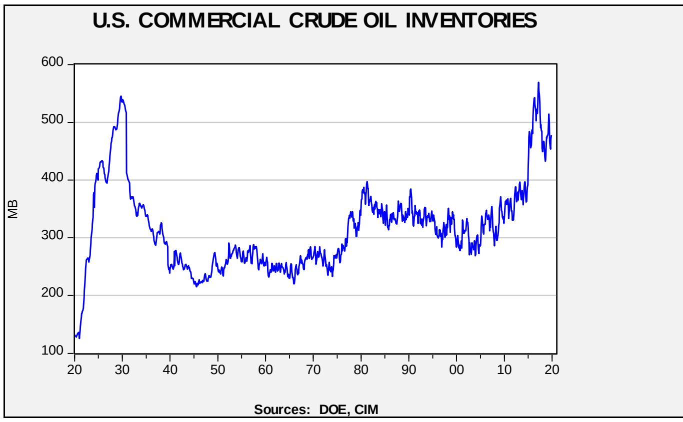
Point #1 would be deadly for Italy, forcing banks to increase their capital because they hold lots of Italian government bonds. Point #2 will make banks in Greece engage in massive asset liquidation and point #3 undermines Ireland's corporate policy. Without changes, the German plan looks dead on arrival, but simply putting it out there will allow Germany to say it supports bank deposit insurance; so, it has some PR value, but little more.

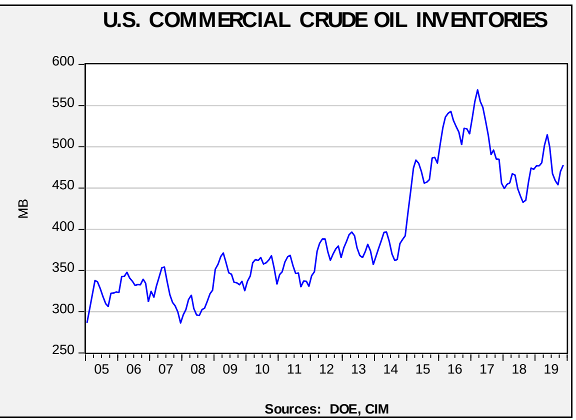
In other German news, Defense Minister Annegret Kramp-Karrenbauer, who is also leader of the governing Christian Democratic Party, said in a speech today that Germany should be "more courageous" in pursuing its strategic interests and should take a more muscular approach to international security, including boosting its defense budget and beefing up its military presence in Africa and Asia. In part, her appeal probably reflects pressure from President Trump. However, it also probably reflects the new dynamics we'll see as the United States pulls back from its traditional role as global hegemon. ***A key question is: Does anyone really want to see Germany rearm?***

Spanish elections: Spain goes to the polls on Sunday for the fourth time in four years. Voting intentions suggest it will probably lead to another inconclusive result.

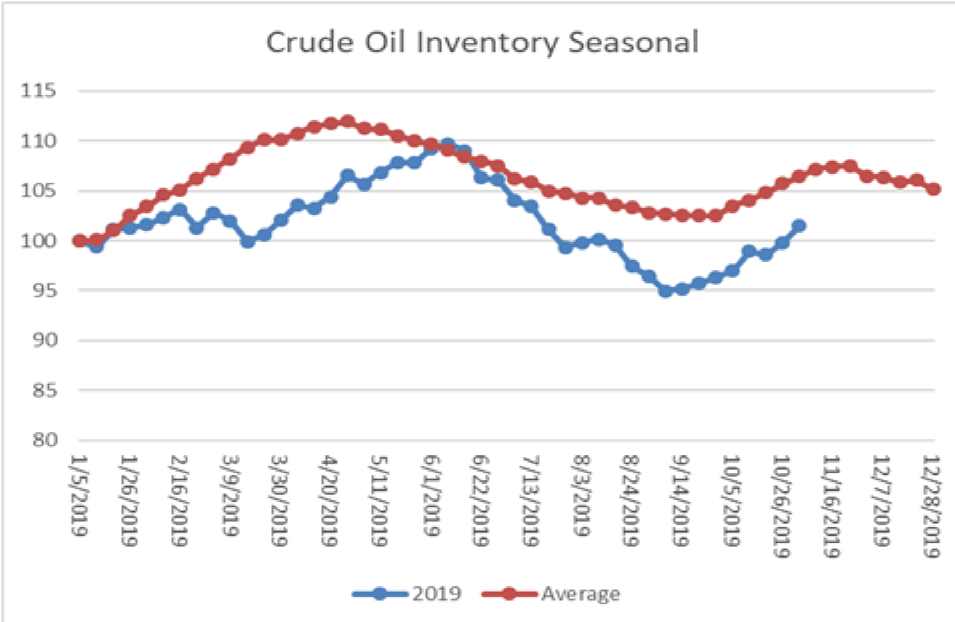
BOE: The Bank of England, as expected, left rates unchanged but there were two dissents calling for a rate cut. The GBP fell on the news.

Energy update: Crude oil inventories rose 7.9 mb compared to an expected build of 2.0 mb.





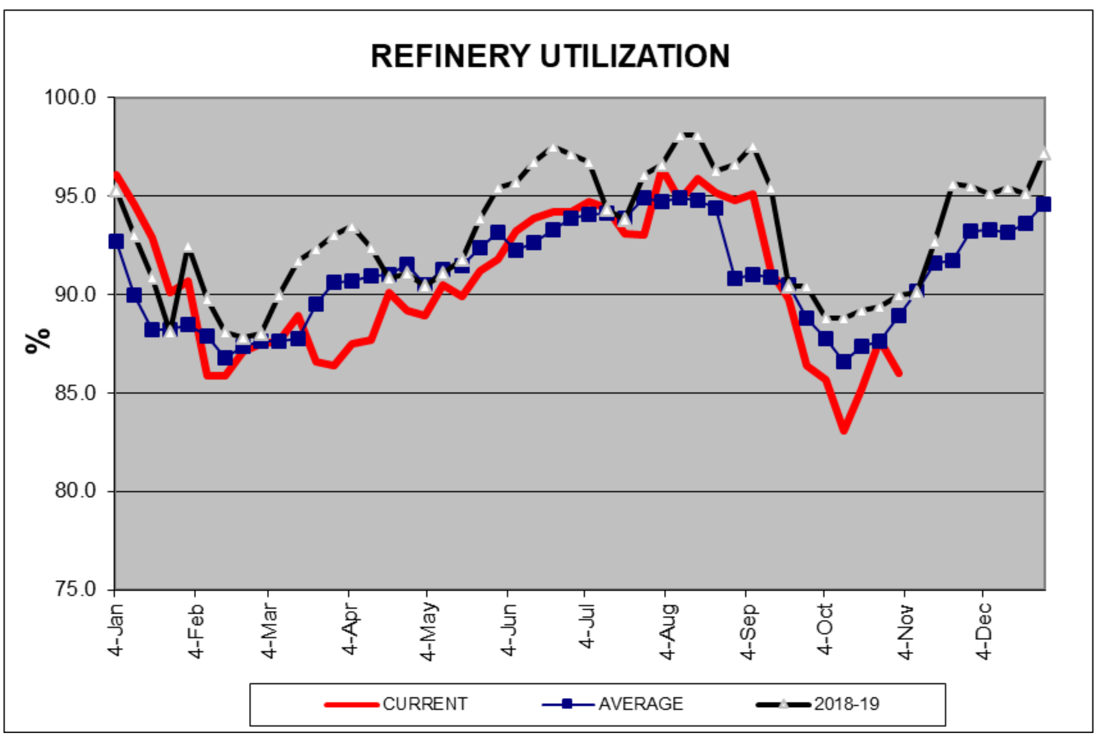
In the details, U.S. crude oil production was unchanged at 12.6 mbpd. Exports fell 1.0 mbpd while imports declined 0.6 mbpd. The unexpected rise in stockpiles was mostly due to falling exports and weaker refinery demand.



(Sources: DOE, CIM)

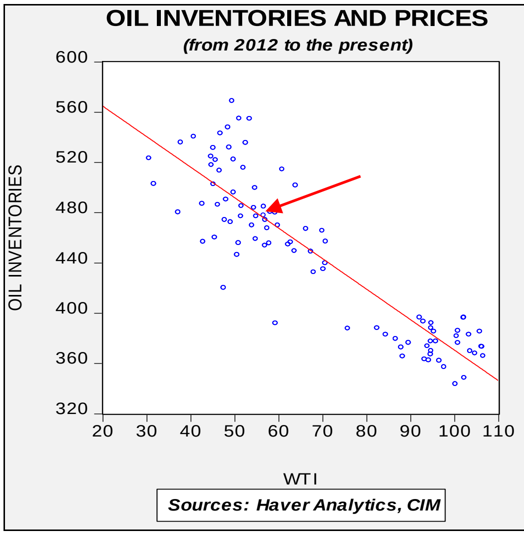
This chart shows the annual seasonal pattern for crude oil inventories. We are now into the autumn build season which usually lasts into early December. This week's rise is normal, but the pace is accelerated.

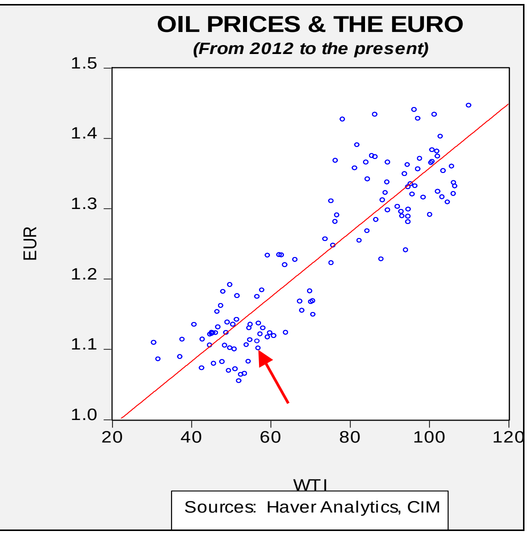
We continue to monitor the autumn refinery maintenance season.



(Sources: DOE, CIM)

This week's drop in utilization is unusual; we would expect a recovery next week.

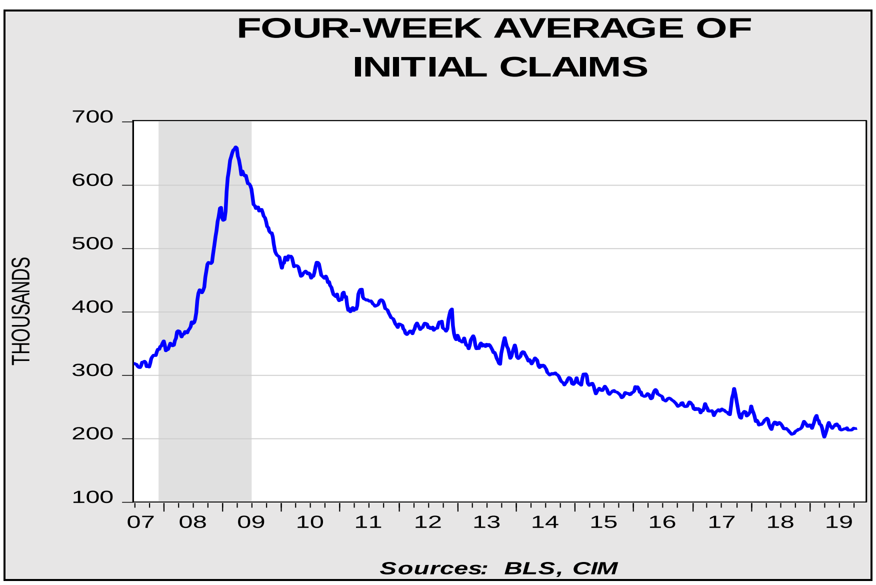




Based our oil inventory/price model, fair value is \$58.53; using the euro/price model, fair value is \$50.13. The combined model, a broader analysis of the oil price, generates a fair value of \$52.23. We are seeing the divergence between dollar and oil inventories narrow as the dollar weakens and oil stocks rise. We expect the Saudi IPO process to support oil and any positive news on the trade front has been lifting oil prices as well.

U.S. Economic Releases

Initial jobless claims came in below expectations at 211k compared to the forecast of 215k. The prior report was revised upward from 218k to 219k.



The chart above shows the four-week moving average for initial claims. The four-week moving average rose from 215.00k at 215.25k.

The table below lists the Federal Reserve events scheduled for the rest of the day.

Economic Releases						
EDT	Indicator			Expected	Prior	Rating
9:45	Bloomberg Consumer Comfort	m/m	nov		61.0	**
15:00	Consumer Credit	m/m	sep	$15.000 Bil	$17.901 Bil	**
Fed Speakers or Events						
	Speaker or event	**District or position**				
13:05	Robert Kaplan Speaks in Dallas	President of the Federal Reserve Bank of Dallas				
19:10	Raphael Bostic Speaks in New York on Monetary Policy	President of the Federal Reserve Bank of Atlanta				

Foreign Economic News

We monitor numerous global economic indicators on a continuous basis. The most significant international news that was released overnight is outlined below. Not all releases are equally significant, thus we have created a star rating to convey to our readers the importance of the various indicators. The rating column below is a three-star scale of importance, with one star being the least important and three stars being the most important. We note that these ratings do change over time as economic circumstances change. Additionally, for ease of reading, we have also color-coded the market impact section, which indicates the effect on the foreign market. Red indicates a concerning development, yellow indicates an emerging trend that we are following closely for possible complications and green indicates neutral conditions. We will add a paragraph below if any development merits further explanation.

Country	Indicator			Current	Prior	Expected	Rating	Market Impact
ASIA-PACIFIC								
China	Foreign Reserves	m/m	oct	3.105 Tril	3.092 Tril	3.100 Tril	*	Equity and bond neutral
Japan	Tokyo Average Office Vacancies	m/m	oct	1.63	1.64		**	Equity and bond neutral
Australia	AiG Performance of Constuction Index	m/m	oct	43.9	42.6		**	Equity bullish, bond bearish
EUROPE								
Germany	Markit Germany Construction PMI	m/m	oct	51.5	50.1		**	Equity bullish, bond bearish
	Industrial Production	m/m	oct	-4.3%	-4.0%	-4.4%	**	Equity and bond neutral
Switzerland	Foreign Currency Reserves	m/m	oct	779.1 Bil	776.9 Bil		**	Equity and bond neutral
Russia	Light Vehicle Car Sales	y/y	oct	-5.2%	-0.2%	-0.6%	*	Equity and bond bearish
AMERICAS								
Mexico	CPI	y/y	oct	3.0%	3.0%	3.0%	***	Equity and bond neutral
	CPI core	m/m	oct	0.3%	0.3%	0.3%	***	Equity and bond neutral
Brazil	IBGE Inflation IPCA	y/y	oct	2.5%	2.9%	2.5%	***	Equity and bond neutral

Financial Markets

The table below highlights some of the indicators that we follow on a daily basis. Again, the color coding is similar to the foreign news description above. We will add a paragraph below if a certain move merits further explanation.

	Today	Prior	Change	Trend
3-mo Libor yield (bps)	189	191	-2	Down
3-mo T-bill yield (bps)	152	152	0	Neutral
TED spread (bps)	38	39	-1	Neutral
U.S. Libor/OIS spread (bps)	156	155	1	Up
10-yr T-note (%)	1.88	1.83	0.05	Down
Euribor/OIS spread (bps)	-41	-40	-1	Neutral
EUR/USD 3-mo swap (bps)	14	12	2	Down
Currencies	**Direction**			
dollar	Down			Up
euro	Up			Up
yen	Down			Down
pound	Down			Up
franc	Flat			Up
Central Bank Action	**Current**	**Prior**	**Expected**	
Bank of England Bank Rate	0.750%	0.750%	0.750%	On forecast
BOE Asset Purchase Target	10 Bil	10 Bil	10 Bil	On forecast
BOE Corporate Bond Target	435 Bil	435 Bil	435 Bil	On forecast

Commodity Markets

The commodity section below shows some of the commodity prices and their change from the prior trading day, with commentary on the cause of the change highlighted in the last column.

	Price	Prior	Change	Explanation
Energy Markets				
Brent	$62.50	$62.96	-0.73%	
WTI	$56.90	$57.23	-0.58%	
Natural Gas	$2.87	$2.86	0.17%	
Crack Spread	$16.92	$17.07	-0.89%	
12-mo strip crack	$18.45	$18.57	-0.66%	
Ethanol rack	$1.67	$1.67	-0.14%	
Metals				
Gold	$1,486.23	$1,483.61	0.18%	
Silver	$17.51	$17.58	-0.38%	
Copper contract	$269.45	$270.05	-0.22%	
Grains				
Corn contract	$ 383.25	$ 381.75	0.39%	
Wheat contract	$ 517.50	$ 515.25	0.44%	
Soybeans contract	$ 934.50	$ 934.25	0.03%	
Shipping				
Baltic Dry Freight	1656	1675	-19	
DOE inventory report				
	Actual	**Expected**	**Difference**	
Crude (mb)	7.9	2.0	5.9	
Gasoline (mb)	-2.8	-2.0	-0.8	
Distillates (mb)	-0.6	-1.3	0.6	
Refinery run rates (%)	-1.70%	0.75%	-2.45%	

Weather

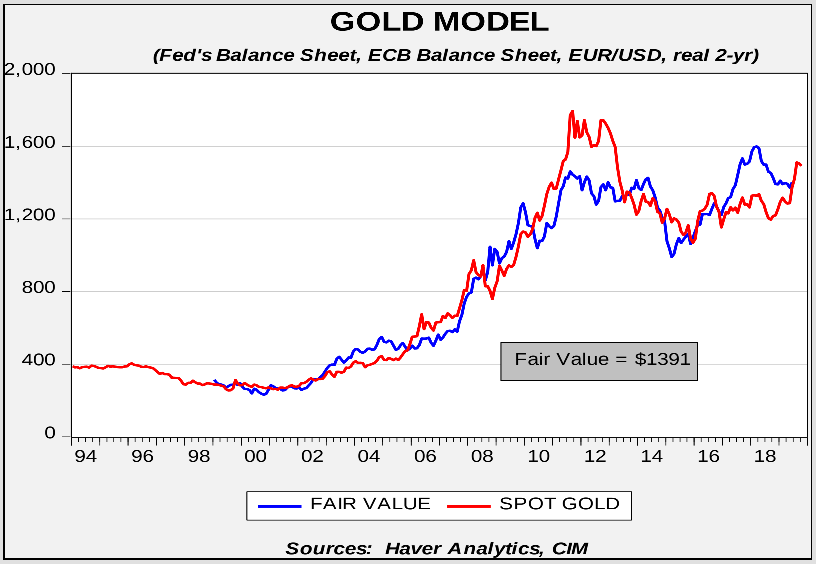
The 6-10 and 8-14 day forecasts call for much colder-than-normal temperatures for the Midwest and East Coast, with warmer-than-normal temperatures in California and the Southwest. Wet conditions are expected in the south, while unusually dry conditions are anticipated throughout the West.

Asset Allocation Weekly

Confluence Investment Management offers various asset allocation products which are managed using "top down," or macro, analysis. We report asset allocation thoughts on a weekly basis, updating this section every Friday.

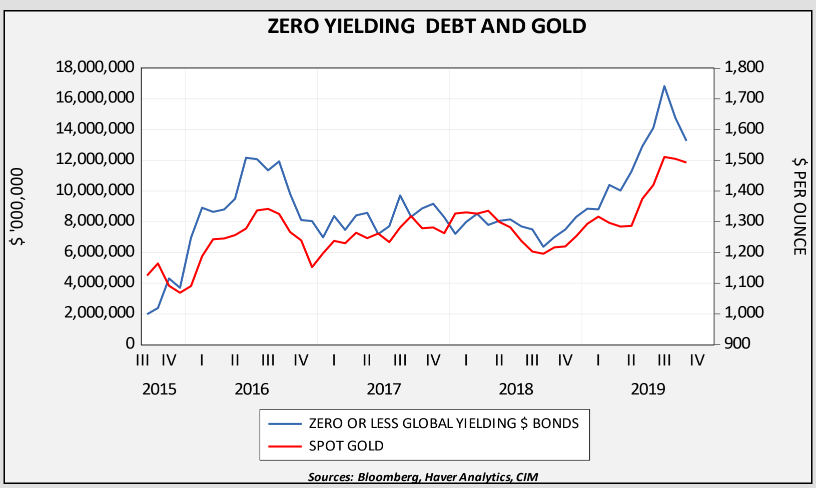
November 1, 2019

We continue to hold a favorable outlook toward gold despite evidence that current prices may be getting a bit ahead of themselves. Our gold model puts fair value at 1391.



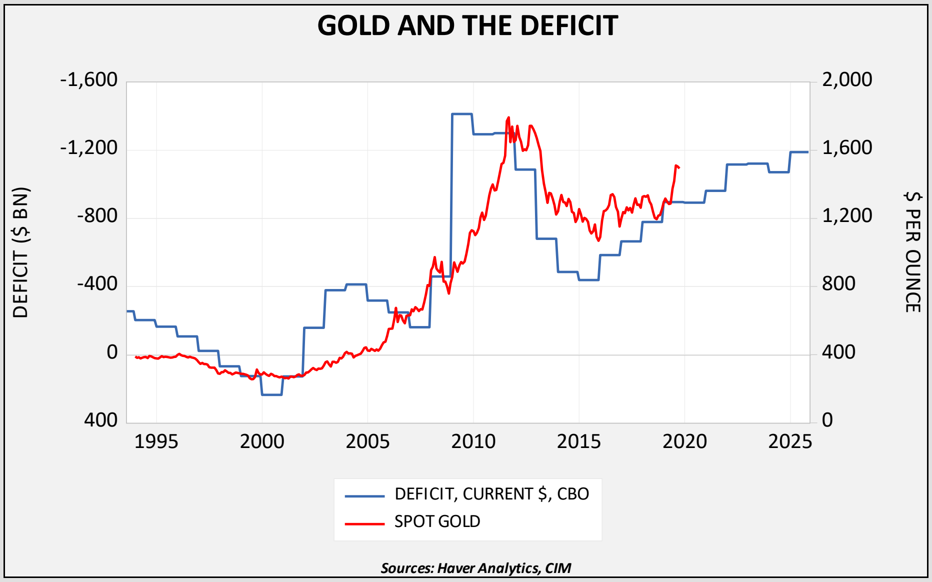
In the coming months, we expect the fair value to rise; both the ECB and the Federal Reserve have resumed expanding their balance sheets. And, the Fed will likely continue to cut rates, which would be expected to reduce the real interest rate on two-year T-notes. The dollar remains overvalued but will likely need a catalyst to trigger depreciation. Still, over time, we do expect gold prices to find support from improving fundamentals.

In addition, the high level of zero-yielding debt should be supportive.



We have seen a drop in zero-yielding debt recently, but with slowing global economic growth, a renewed expansion is likely.

Finally, there is a long-term relationship between gold prices and the level of the fiscal deficit. Although the level of the current deficit does suggest, again, that gold prices might be a bit overvalued currently, the likelihood of expanding deficits should offer underlying support for gold prices.

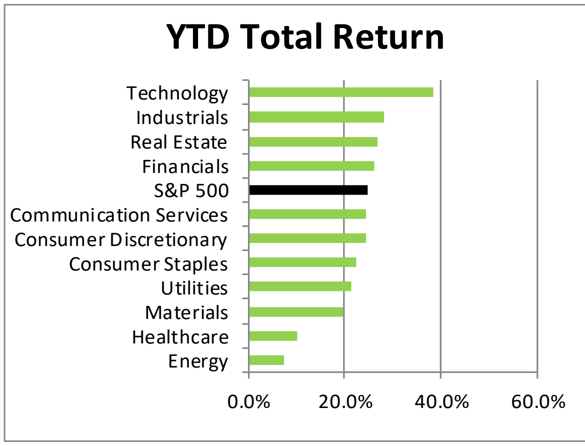


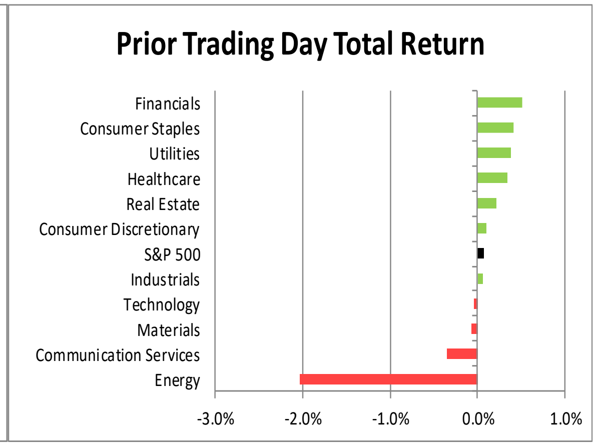
In the immediate term, we may see steady to lower gold prices but there are ample fundamental factors that should support future prices.

Past performance is no guarantee of future results. Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice or a recommendation. The investment or strategy discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Opinions expressed are current as of the date shown and are subject to change.

Data Section

U.S. Equity Markets – (as of 11/6/2019 close)

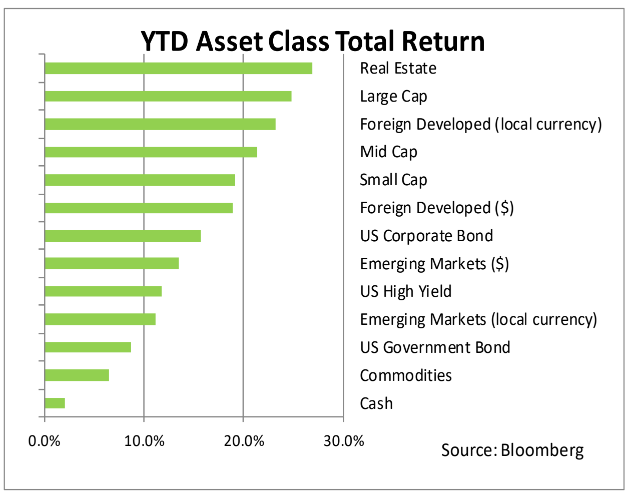




(Source: Bloomberg)

These S&P 500 and sector return charts are designed to provide the reader with an easy overview of the year-to-date and prior trading day total return. Sectors are ranked by total return; green indicating positive and red indicating negative return, along with the overall S&P 500 in black. These charts represent the new sectors following the 2018 sector reconfiguration.

Asset Class Performance – (as of 11/6/2019 close)

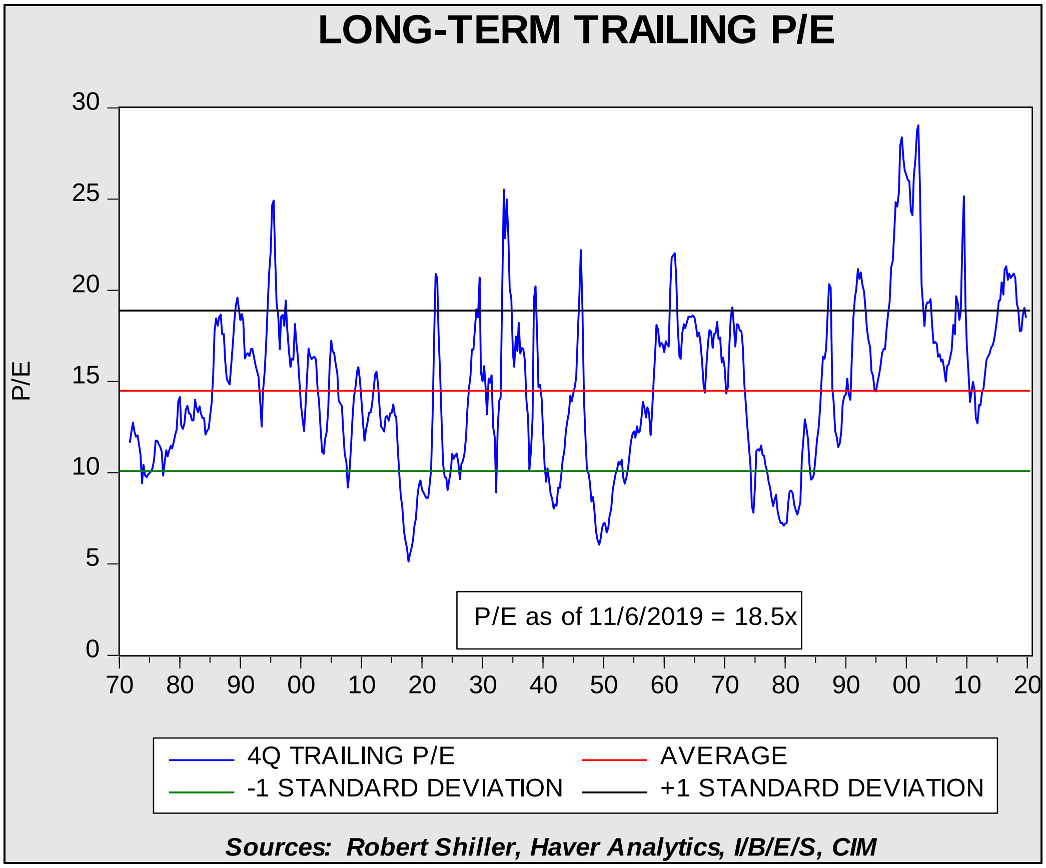


This chart shows the year-to-date returns for various asset classes, updated daily. The asset classes are ranked by total return (including dividends), with green indicating positive and red indicating negative returns from the beginning of the year, as of prior close.

Asset classes are defined as follows: Large Cap (S&P 500 Index), Mid Cap (S&P 400 Index), Small Cap (Russell 2000 Index), Foreign Developed (MSCI EAFE (USD and local currency) Index), Real Estate (FTSE NAREIT Index), Emerging Markets (MSCI Emerging Markets (USD and local currency) Index), Cash (iShares Short Treasury Bond ETF), U.S. Corporate Bond (iShares iBoxx $ Investment Grade Corporate Bond ETF), U.S. Government Bond (iShares 7-10 Year Treasury Bond ETF), U.S. High Yield (iShares iBoxx $ High Yield Corporate Bond ETF), Commodities (Bloomberg total return Commodity Index).

P/E Update

November 7, 2019



Based on our methodology,[1] the current P/E is 18.5x, up 0.1x from last week. The rise in the P/E is due to higher equity prices.

This report was prepared by Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change. This is not a solicitation or an offer to buy or sell any security.

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[1] This chart offers a running snapshot of the S&P 500 P/E in a long-term historical context. We are using a specific measurement process, similar to *Value Line*, which combines earnings estimates and actual data. We use an adjusted operating earnings number going back to 1870 (we adjust as-reported earnings to operating earnings through a regression process until 1988), and actual operating earnings after 1988. For the current quarter, we use the I/B/E/S estimates which are updated regularly throughout the quarter; currently, the four-quarter earnings sum includes two actual quarters (Q1 and Q2) and two estimates (Q3 and Q4). We take the S&P average for the quarter and divide by the rolling four-quarter sum of earnings to calculate the P/E. This methodology isn't perfect (it will tend to inflate the P/E on a trailing basis and deflate it on a forward basis), but it will also smooth the data and avoid P/E volatility caused by unusual market activity (through the average price process). Why this process? Given the constraints of the long-term data series, this is the best way to create a long-term dataset for P/E ratios.